SUMMARY OF COMMENTS, RESPONSES AND RECOMMENDATIONS REGARDING PROPOSED AMENDMENT TO REGULATION SECTION 17951-4 HEARING NOTICED DECEMBER 9,1999

1. Comment: The terms "subdivision" and "subsection" are used interchangeably throughout the text. (Alan D. Bollinger, KPMG Peat Marwick, December 5, 2000.)

   Response: The term "subsection" is used throughout the regulation when referring to particular provisions within the regulation, except that the term "subdivision" is used in subsection (d)(5)(A).

   Recommendation: Change the term "subdivision" in subsection (d)(5)(A) to "subsection" to maintain consistency.

2. Comment: The first sentence of subdivision (g) refers to the practice of a profession in "subdivision (g) below." The reference should be to subdivision (h). (Alan D. Bollinger, KPMG Peat Marwick, December 5, 2000.)

   Response: The reference to subsection (g) was inadvertently not changed when proposed changes to the regulation caused the text of former subsection (g) to be moved to subsection (h).

   Recommendation: Change the reference in subsection (g) to subsection (h).

3. Comment: Consideration should be given to making the amendment prospective so that amended returns will not be required and penalties will not be assessed upon its adoption. (Alan D. Bollinger, KPMG Peat Marwick, December 5, 2000)

   Response: There are four essential changes proposed in the amendment: (1) Personal income tax rules for assigning nonbusiness income of a multistate trade or business are substituted for corporate nonbusiness allocation rules in computing California source income of a nonresident owner; (2) Unitary combination is not generally required if a nonresident individual owns less than a 20 percent interest in an entity; (3) Rules of unitary combination are applied to nonresident individuals who own a 20 percent or more interest in an entity; and (4) Rules for sourcing income of nonresident partners will generally be applied to nonresident shareholders of S corporations.

   Existing case law already requires nonresident individuals who own interests in a unitary trade or business to compute California source income by using combined reporting. Likewise, nonresident shareholders of S corporations are already required to source their pro rata shares of income by using rules identical to those for sourcing partnership income. (*Valentino* v. *Franchise Tax Board*, (2001) ___Cal. App. 4th ___; *Appeal of Manter*, 99-SBE 008.) The only amendments that create a change in the law are the requirement to use Personal Income Tax sourcing rules to assign nonbusiness income and the 20% threshold for applying the presumption against combined reporting.

Recommendation: The provisions requiring nonresident owners of a multistate trade or business to use Personal Income Tax sourcing rules rather than corporate allocation rules for assigning nonbusiness income should be prospective. So should the provision that creates a presumption against combined reporting if a nonresident individual owns less than a 20% percent interest in a trade or business. All other changes should apply in the computation of taxes for all open taxable years.

SUMMARY OF COMMENTS, RESPONSES AND RECOMMENDATIONS REGARDING PROPOSED REGULATION SECTION 17951-6 HEARING NOTICED DECEMBER 9, 1999

1. Comment: The proposed regulation does not take into account the requirement that there be a connection between the thing being taxed and California. (Roy E. Crawford, Brobeck Phleger & Harrison, January 18 and 19, 2001.)

   Response: When California seeks to tax income from a covenant not to compete, the thing being taxed is income from forfeiting a right to conduct business within a jurisdiction. A connection with California exists when California is the place, in whole or in part, where the individual forfeits the right to do so. Revenue and Taxation Code section 17041(b) imposes tax on nonresident individuals on income derived from sources within this state. Income from a covenant not to compete is income from property[1] the source of which is the place where the promisor forfeited the right to act. (*Korfund v. Comr.* (1943) 1 T. C. 1180; *Appeal of Milhous*, 2000 SBE-003; *Appeal of Pesiri*, Cal. St. Bd. of Equal., Sept. 26, 1989; FTB Legal Ruling No. 084 (1958).) The promisor forfeits the right to act in the locations where the covenant is legally enforceable. That area is defined by the terms of the covenant but cannot be an area greater than where business was historically conducted by the entity sold. (Cal. Bus. & Prof. Code section 16600 et seq.) Accordingly, the jurisdictional connection is established by the fact that the nonresident promises not to compete within California.

   Using the apportionment factors of the business sold insure that there is a connection between California and the income being taxed. First, the location of business activity defines the outer limit beyond which covenants are not enforceable. (Cal. Bus. & Prof. Code section 16600 et seq.) Terms of a typical covenant prohibit competition where business was conducted. If the covenant specifies a greater area, it is enforceable only

[1] It is well settled that a state has the power to tax income from property within the state. (*Shaffer* v. *Carter*, (1920) 252 U.S. 37; *International Harvester* v. *Washington* (1944) 322 U.S. 435.) It is not necessary that the nonresident be present within the state to confer taxing jurisdiction. (*Wisconsin* v. *J.C. Penney Co.* (1940) 311 U.S. 435.)

within the area of historical business activity. (Cal. Bus. & Prof. Code section 16601.) In either situation, the enforceable geographic scope of the covenant is where the business conducted activity. The apportionment factors of the business sold assign income to those areas.[2]

Second, the factors of the business sold reflect the type of activities prohibited by the covenant. The terms of a typical covenant prohibit competition where all phases of business was carried on and in terms of the type of activities conducted. Using the sales factor to assign income from a covenant reflects the prohibition on selling to existing customers. The payroll factor reflects the prohibition on soliciting employees or using employees in competition generally. The property factor represents the promise not to use property in competition. Thus, the types of prohibited activities specified in a typical covenant not to compete are reflected in the apportionment factors of the business sold.[3]

Third, the factors recognize that a business competes for sales to customers, qualified employees and suitable property sites and desires protection from competition where sales are made and where its resources are employed. Since the purpose of a covenant not to compete is to prevent all forms of unwanted competition, the use of these factors assigns covenant income to where the buyer seeks protection.

Accordingly, a connection exists between the thing being taxed and California because income is assigned to this state to the extent that California is included in the enforceable area of abstinence according to the types of prohibited activities historically conducted here. In addition, the income is assigned to California to the extent the buyer competes for sales and resources in California and would suffer harm in California from competition.

Recommendation: No change.

2. <u>Comment</u>: The proposed regulation does not contain an adequate definition of what constitutes a covenant not to compete. It is unclear whether promises not to invest in a competitor, not to solicit employees and not to divulge confidential information are included in the definition. (Roy E. Crawford, Brobeck Phleger & Harrison, January 18 and 19, 2001.)

   <u>Response</u>: The proposed language states that a covenant not to compete includes any arrangement to refrain from engaging in an activity, directly or indirectly, similar to the business activity carried on by the business that was sold. This broad language is intended to include all forms of promises that have at their core the protection against

[2] If the terms of a covenant prohibit competition in a smaller area, the corporate factors used are those within the smaller area. Thus covenant income is always assigned to the legally enforceable area of abstinence.
[3] If the types of prohibited activity or the degree of business activity is not reflected by the corporate apportionment factors, with the result that there is a gross distortion of income assigned to California, the taxpayer may petition, or the Franchise Tax Board may require, the use of another method.

interference in business activity through competition.[4] It is intentionally broad to cover all the various forms of covenants found in practice and to discourage attempts to draft language that would circumvent a more specific definition while still protecting the buyer against competition. The term "indirectly" includes promises not to acquire an interest in a competitor, promises not to disclose proprietary information, and promises not to solicit employees. The State Board of Equalization was confronted with these variations in *Appeal of Milhous, supra,* and assigned income therefrom according to an apportionment formula that looked to the factors of the business which was sold.

Recommendation: Include types of promises in the definition of a covenant not to compete.

3. Comment: The proposed regulation does not assign income to all the locations where the parties agreed not to compete in the circumstance where the geographic scope of the covenant includes areas where the corporation intends to expand business operations. The relief clause does not provide guidance. (Roy E. Crawford, Brobeck Phleger & Harrison, January 18 and 19, 2001.)

   Response: As explained earlier, a covenant not to compete is enforceable under California law only within those geographic boundaries where the business was conducted by the entity which was sold. (Cal. Bus. & Prof. Code section 16600, et seq.) This provision is a codification of the common law rule that restraints against trade must be reasonable as to time, location and activity.[5] (Farnsworth, *Contracts*, ¶5.3, p. 339, Little, Brown & Co., 1982.) A covenant is not enforceable within areas the buyer intends to expand if the entity sold has not already conducted business in that location. Conducting business in this sense means more than infrequent or insubstantial activities. (*Swenson* v. *File* (1970) 3 Cal. 3d 389.) Because the sphere of prohibition is not enforceable in areas of planned expansion, no income should be assigned to those locations.

   Regulation subsection (a)(6) permits the taxpayer to petition for, or the Franchise Tax Board to require, the use of another method to assign income from a covenant if the use of the apportionment factors of the business in the year of sale results in a gross distortion of income being assigned to California. This subsection was never intended to alter the rule that the income must be assigned to the legally enforceable area of abstinence, only to provide flexibility if reliance on the factor formula to assign income within that area produces gross distortion. The enforceable area of abstinence is fixed by the terms of the covenant as limited by California law.

   Recommendation: Add language to subsection (a)(6)(B) stating that the use of another method of allocation or the use of different years' factors must be applied to assign income within the legally enforceable area of abstinence.

[4] Internal Revenue Code section 197(d) also uses broad language in describing a covenant not to compete.
[5] Courts routinely reform overly broad covenants to comply with the limits of the law. (*Swenson* v. *File, supra*.)

4. Comment: If the proposed regulation were to include areas within which the business intended to expand, what would prevent taxpayers from artificially drafting worldwide language to avoid paying California tax? In such a circumstance how would the covenant income be assigned? (Ben Miller, Franchise Tax Board, January 19, 2001.)

   Response and Recommendation: See Response and Recommendation to Item 3. above.

5. Comment: The proposed regulation is contrary to constitutional requirements when applied to nonresidents with no connections or limited connections with California because it seeks to tax income without having provided protections, opportunities or benefits to such individuals. The clause that permits the Franchise Tax Board to forgo taxation if to do so would violate federal statutes or the United States Constitution is inadequate because it is unnecessary and does not provide guidance. (Roy E. Crawford, Brobeck Phleger & Harrison, January 18 and 19, 2001.)

   Response: There is no constitutional bar on the power of a state to tax income from property located within its borders. (*Shaffer* v. *Carter*, *supra*.) Income from a covenant not to compete is income from property having a situs where competition is prohibited. (*Korfund* v. *Comr., supra; Appeal of Pesiri, supra; Appeal of Milhous, supra*.) The property referred to is the right to compete in California.[6] California confers benefits and protections to holders of this right because the laws and government of California benefit and protect business entities and activities conducted within this State. The proposed language regarding the prohibition is unnecessary.

   Recommendation: Delete the phrase "and to the extent that the taxation of the assigned income is not prohibited by federal statutes or by the federal or California Constitution."

6. Comment: Because the proposed regulation seeks to tax income of nonresidents who may have no connection with California, voluntary compliance will be meager and inconsistent. Enforcement activity will be selective because the Franchise Tax Board will examine only tax returns of individuals with unrelated income. (Roy E. Crawford, Brobeck Phleger & Harrison, January 18 and 19, 2001.)

   Response: The principles expressed in this regulation are not new or unique to California. The Franchise Tax Board first adopted the principle that the source of income from a covenant not to compete is the place where the promisor forfeited the

[6] In the case of a sale or other disposition of property, the source of income is determined by reference to that which was tendered. (See, e.g., Regulation section 17951, which states that income from the disposition of real and personal property has a source where the property is located.) Income from a covenant is income from the surrender of a right to compete within a prescribed location. The right is an intangible property right with a situs in the specified location. Some cases have characterized income from a covenant not to compete or a contract analogous to a covenant not to compete as income from nonperformance of services as opposed to income from property. However, these cases address whether covenant income is eligible for the installment method of accounting or involve the termination of what is essentially an employment or service contract. They have no application where the issue is the source of income from a covenant executed in connection of the sale of a business.

right to compete in 1958. (FTB Legal Ruling No. 084 (1958).) The Board of Equalization affirmed that principle in 1982. (*Appeal of Washburn,* Cal. St. Bd. of Equal., June 29, 1982.) So have the federal government and other states. (*Korfund, supra; Sar,* Iowa Dept. of Rev., 1997 Iowa Tax LEXIS 9; Minn. Stat. Ch. 290, Sec 290.17(c); Ore. TLA, 316.127; Conn. Reg. sec. 12-711(b)-20). This regulation, if adopted, will provide further authority and be readily available to tax practitioners. In addition, the fact that the business sold conducted activity within California should alert a reasonably prudent tax practitioner to inquire as to whether income from a covenant not to compete associated with the sale has a source in California.

The comment concerning selective enforcement is speculative at best and is unsupportable. Franchise Tax Board staff is bound to follow its regulations in all situations and is notified when a corporation dissolves or ceases activity in California by the requirement for such corporations to obtain a tax clearance certificate with the Franchise Tax Board. Taxpayers reporting income from partnerships, S corporations, and limited liability companies treated for tax purposes as partnerships will have filed California tax returns for years prior to and including the sale of the business.

Recommendation: No change.

7. Comment: The amount of income from a covenant not to compete should be assigned to California in accordance with a formula that looks to the amount of time the individual spent in California performing services for the entity that was sold. In addition, there should be a de minimus rule that would exempt nonresidents with limited prior activity in California. (Roy E. Crawford, Brobeck Phleger & Harrison, January 18 and 19, 2001.)

   Response: Sourcing income from a covenant not to compete in California executed in connection with the sale of a business by looking to where the promisor performed services for the business is not the law in California, nor should it be. Typical covenants connected with the sale of a business prohibit the promisor from engaging in the same or similar activities as those of the business sold. These activities include much more than providing services for a competitor. Thus, assigning income by reference to where the promisor performed services in the past does not conform to the types of activities prohibited. In addition, the place where the individual performed services in the past has no connection with where he promises to refrain from competing in the future.[7] Since income from a covenant has a source where the promisor forfeited the right to act, the locations where he or she performed services has relevance only in that it represents one area in which the business conducted activity. Rarely, if ever, is that location the entire area of abstinence. If it is, the terms of the covenant will reflect that and the income will be assigned exclusively to that area.

[7] The Board of Equalization rejected this very argument in *Appeal of Milhous, supra,* because it does not assign income to the places the promisor agreed to refrain from acting, citing to prior Board opinions in *Appeals of Pesiri* and *Washburn, supra*.

A de minimus rule would necessarily be arbitrary in selecting the amount of the income or tax to be ignored. It would also violate Revenue and Taxation Code section 18501 by creating thresholds that could circumvent those imposed by statute. The rate of tax on California source income is determined by looking to a nonresident's income from all sources. Thus the amount of tax imposed on a fixed amount of California source income varies according to a nonresident's total taxable income. Setting income limits below which an individual would not be subject to tax would be discriminatory because the amount of tax forgiven would be different in every situation.

Recommendation: No change.

8. Comment: Has the Franchise Tax Board been successful applying this formula to assign income from a covenant not to compete in Superior Court or a Court of Appeal? Has the Franchise Tax Board settled litigation for less than the deficiency where the issue was the application of the three-factor formula for assigning covenant income? (David Pathe, January 19, 2001.)

   Response: The factor apportionment methodology employed in this regulation has been the litigating position of the Franchise Tax Board in two lawsuits, both of which were settled, and is the methodology adopted by the State Board of Equalization as reflected in three unpublished decisions and in the published decision *Appeal of Milhous, supra.* While the details concerning the reasons for settling these cases cannot be disclosed, in general, cases are settled taking into account a variety of factors. No inferences can be drawn regarding the validity of applying a factor formula to assign income from a covenant not to compete from the mere fact that these cases were settled.

   Recommendation: No change.

9. Comment: Would the regulation consider throwback sales? (David Pathe, January 19, 2001.)

   Response: Subsection (a)(3) states that sales will always be assigned to the state of destination and that the corporate apportionment rule requiring that sales delivered to customers in states where the seller is not taxable be "thrown back" to the state of shipment will not apply in assigning income from a covenant not to compete. The purpose for not applying the throwback rule is to assign income to all places the covenant prohibits activity and to honor the types of activities prohibited. Covenants not to compete typically define the area in which competition is prohibited by reference to where the business has conducted activity; the prohibited acts typically include all those performed by the business. These locations and acts include both the place where goods are delivered and the act of making deliveries. The fact that the business may not be taxable in a jurisdiction in which sales are delivered does not mean that the covenant is not enforceable there. Accordingly, there is no reason to apply the throwback rules of Revenue and Taxation Code section 25126(b). To do so would artificially assign income to a smaller area than is specified in the typical covenant and a smaller area than that specified in Cal. Bus. & Prof. Code section 16600, et seq.

Recommendation: No change.

10. Comment: Will a definition of what is meant by "a gross distortion of income assigned to California appearing" in Subdivision (a)(6) be provided in the regulation? (Alan D. Bollinger, KPMG Peat Marwick, December 5, 2000.)

    Response: Subsection (a)(6) permits the taxpayer to petition for, or the Franchise Tax Board to require the use of, factors for a different year or years than those used for the year of sale of the business or a different methodology of assigning income from a covenant not to compete within the legally enforceable area of abstinence if the use of the factors of the business for the year of sale produce a gross distortion of income assigned to California. The subsection is similar to Revenue and Taxation Code 25137, which permits the use of another method of apportioning corporate business income to California if the use of the three or four factor formula (depending upon the law in effect for the year of sale) does not fairly represent the extent of the corporate business activity in California. The phrase "gross distortion" was adopted because staff experience and State Board of Equalization decisions confirm that the application of the general rule will produce a proper assignment of income to locations within the enforceable area of abstinence in the vast majority of circumstances. Unless this amendment makes clear that the general rule will be applied in all but unusual situations, it will not provide guidance either to the taxpaying public or to Franchise Tax Board staff. Rather it will lead to frequent and continuing disputes as to the proper apportionment methodology to be used.
    The terms are not defined with precision because, like Revenue and Taxation Code section 25137, what constitutes a gross distortion of income in one circumstance may not be in another. All that can be reasonably stated is that gross distortion must be measured by looking at the relationship between the factors employed and the degree of recent historical business activity conducted within the prohibited area, and the nature of activities prohibited by the covenant.

    Recommendation: Change the language of subsection (a)(6) to make clear that the general rule will be applied in all but unusual circumstances and that gross distortion must be measured only by the relationship between the factors of the business for the year of sale, the degree of recent historical business activity conducted by the business within the enforceable area of prohibition, and the nature of activities prohibited by the terms of the covenant.

11. Comment: How would a minority shareholder who executed a covenant not to compete in connection with the sale of the corporation obtain access to the information necessary to compute the amount of income assigned to California? (Alan D. Bollinger, KPMG Peat Marwick, December 5, 2000.)

    Response: Buyers of multistate corporations typically extract covenants not to compete from individuals with the means and expertise to compete in such a manner as to jeopardize the continuing success of the corporation. These individuals are typically founders of corporations, majority shareholders and/or key employees who have developed or acquired product knowledge, customer contacts, or operations skills, etc., sufficient to present a serious threat to the corporation. These individuals have access rights to corporate records and tax returns. Publication of this regulation will place individuals and tax advisors on notice that income from covenant covenants executed in connection with the sale of a business is assigned to California by using the corporate apportionment factors and should thus aid in compliance.

Recommendation: No change.

12. Comment: Shouldn't the regulation be prospective in application so that amended returns and penalties won't be required upon the adoption? (Alan D. Bollinger, KPMG Peat Marwick, December 5, 2000.)

    Response: The methodology prescribed in the amendments to this regulation generally follows the decision in *Appeal of Milhous, supra*. That decision addressed the taxability of a covenant not to compete executed in 1993. The unpublished decisions applying the same general methodology addressed covenants not to compete executed as early as 1987.

    If this amendment were to be prospective in operation, an inference could be drawn that the Franchise Tax Board will not require the use of the factor apportionment method for covenants not to compete executed in earlier years. Such is not the case. Whether or not this amendment is adopted on a prospective or retroactive basis, or whether it is adopted at all, the Franchise Tax Board will follow the decision in *Appeal of Milhous* and the earlier decisions in all administrative and judicial matters.

    Recommendation: Add subsection (b) to specify when the provisions of the regulation shall apply. Modify subsection (a)(1) to reference Revenue and Taxation Code section 25128(a) so that this subsection is consistent with the application of the provisions of the Revenue and Taxation Code set forth in subsection (a)(3).